THE CZECH REPUBLIC AND THE EURO

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1. Introduction: Czech Republic and Euro

The analysis of the accession of the Czech Republic to the Eurozone (EMU) will deal above all with two closely interconnected issues:

● **How to enter**: What mechanism should be used for the adoption of the euro, what role should Czech institutions play

● **When to enter**: What date of entry is favourable and realistic for the Czech Republic

It is necessary before entry to **consider both economic and political effects of membership** - as well as the effects of membership on the whole project of European. **The accession of the Czech Republic to the Eurozone will be a political decision,** even though purely political elements will be somewhat more constrained than in the case of the EU enlargement, by economic factors.

This analysis will not deal with the question of whether the Czech Republic should join the Eurozone. **With its expressed wish to become a part of the Economic and Monetary Union the Czech Republic implicitly agreed to adopt the Euro**, and therefore, the question of whether or not to join the Eurozone is a non-issue.

It is obvious that the **Euro should not be adopted for its own sake**. This decision should be based on a thorough consideration of costs and benefits of the common currency. This analysis should concentrate on both the economic and the political effects of membership. There is a **wide consensus that the long-term benefits of the monetary union will outweigh the possible costs**. Objections based on the application of the optimal currency area theories are hardly defensible in the light of the economic indicators of the Czech Republic. In addition they are based to a large extent on the original Keynesian version of this theory, without taking into account its more recent development. The Eurozone is relatively less suitable for the adoption of a single currency than, for example the United States, but this doesn't inevitably mean that it is not suitable at all. A strict application of the optimal currency area theory would lead to the disintegration of the EU into small units with their own currencies, with the borders of these new units not corresponding with the current borders of existing national currency areas – that is undoubtedly an absurd idea. Therefore, **we consider the optimal currency area theory to be an unsuitable source of inspiration for the Czech Republic. In the case of the Czech Republic, the most important question is the smoothness and the timing of the accession to the Eurozone.**

2. <u>Possible roads to the Eurozone</u>

2.1. Unilateral euroisation

Unilateral euroisation would mean the **adoption of the Euro as the official currency of the Czech Republic by means of an independent decision, before joining the EU**– as has occured in Kosovo or Montenegro. Discussions of similar ideas have also been raised in Poland and Estonia.

The European Union currently rejects the idea of unilateral euroisation, and **would consider it as a very uncooperative gesture**. In addition, the Czech Republic would give up its own monetary policy without partially compensating for this loss by gaining representation in monetary decision-making within the framework of the European Central Bank (ECB). Another risk of unilateral euroisation is a potentially higher level of inflation. Under current conditions it is therefore not possible to recommend this road.

2.2. The classical model

The **classical model assumes that the Czech Republic will take the same path as the current members of the Eurozone**. This means that it would have to **fulfil the Maastricht convergence criteria**, including the two year "waiting period" in the Exchange Rate Mechanism (ERM II).

From the perspective of the bargaining position of the Czech Republic, this **classical way is the easiest and most probable route for the adoption of the Euro at present**. It is improbable that the conditions of the accession to the Eurozone will change, even though the candidate countries are pressing for an adjustment of the criteria to their specific situation (e.g. Abolishing the obligation to stay in the ERM II for two years, loosening the criterion for inflation or for budget deficits). The argument for adjustment made by the candidate countries is based on the idea that the **conversion criteria were established for the need of the current Eurozone states** and that they are far from being optimal for the new members. On the contrary, on the side of the member states there are proposals for the tightening of the criteria (e.g. introducing new conditions concerning the "real" convergence of the candidate countries). Therefore, the status quo is probably going to remain with the future possibility of its change, if e.g. Great Britain or Sweden would negotiate a modification of the conversion criteria (see below).

The disadvantage of the classical (Maastricht) model of the EMU accession process is the delay of Czech membership in the Eurozone for at least two years after the accession to the EU (because it is unlikely that the candidate countries would be accepted to the ERM II before they become members of the EU, for example already in 2003). The other disadvantages are the costs related to keeping the exchange rate of the Czech *Koruna* within the required band (in relation to the Euro).

2.3. Accelerated accession

The model of accelerated accession assumes a shortening (or complete omission) of the obligatory two year stay in the ERM II. The Czech Republic could therefore join the Eurozone already in the moment of its accession to the EU or shortly afterwards. This model demands that the ECB (and therefore, the Eurozone states) would be willing to soften the conditions for a newly accessing state. However, the ECB has already expressed its reluctance to this idea – in case of Estonia, which in fact already fulfils the conversion criteria.

Current EU member states outside the Eurozone (Great Britain, Denmark, Sweden) **could become allies of the Czech Republic** during the negotiations about accelerated accession **in the case that they would adopt the Euro** – one cannot expect that e.g. Britain would be willing to go through several years of "waiting" in the ERM II. Thus one scenario for accelerated accession would be that the Czech Republic, and other new member states, could "get a lift" with the exemption negotiated by these EU members.

Another situation in which the Eurozone states and the ECB could agree accelerated accession **to the EMU of new member states is if there was a significant financial crisis in the candidate countries before their accession to the EU. An accelerated adoption of the Euro could be used as an instrument for their stabilisation and could be put into one "package" with the EU enlargement.**

3. Convergence criteria and the Czech Republic

In order to join the Eurozone, taking either the accelerated or the classical route, the Czech Republic will have to fulfil the **convergence criteria.** The most important factors for the Czech Republic are inflation, public-sector budget deficit, and exchange rate stability. **Another significant factor will be whether the EU, particularly the ECB, will strictly enforce the fulfilment of the convergence criteria** or if it will be enough for the Czech Republic to converge to their fulfilment. The second variant is, of course, more comfortable one for the Czech Republic.

3.1. Inflation

The convergence criterion for inflation requires that the rate of inflation in a acceding country, **may not to exceed by more than 1,5% the average inflation of the three EU countries with the lowest level of inflation.** With the inflation target of the Czech National Bank (2-4% in 2005) there is a chance that this condition will be fulfilled. Unfortunately, it is not the inflation target of the central bank which is **decisive**, it is **the actual inflation before accession**.

There is a **crucial objection** regarding the inflation limiting criterion: **the candidate countries still have the characteristics of transforming economies and thus they are theorised to have a higher optimal inflation rate than the current members of the EU.** The Czech Republic is rather anomalous, because the Czech price level is lower than that of other candidate countries, including countries with lower GDP per capita. The price level is approximately 45% of the EU average and there are significant differences not only in the sector of non-tradable goods but also tradable goods (where the prices should be theoretically identical with the EU due to arbitrage effects). The reason for that could be, for example, the worse reputation of Czech products in the EU, regardless their quality. Above all, some prices are still subject to regulation in the Czech Republic. **The future potential for price growth is therefore high in the Czech Republic**. All these factors can lead in the future to a higher level of inflation without endangering the price stability. In the case of quickly growing economies the **economic theory assumes a faster rise in the prices of the non-tradable sector** (on the basis of the "Balassa-Samuelson effect"). Empirical studies confirm this effect in most cases, but they hardly agree on its extent. The estimates usually vary in a broad span of one to five percent faster growth in the price of non-tradables. **One can expect that the higher growth of prices of non-tradable goods in the Czech Republic will be closer to the lower boundary of this interval** Even in the case when the higher inflation would reflect a faster growth of prices of non-tradable goods (e.g. due to a rising quality of Czech products or their better reputation on foreign markets) it will neither mean a problem for the competitiveness of the economy nor generate harmful, destabilising inflation effects.

The price jump related to the EU enlargement (and the following significant rise in inflation) **will take place after the accession but it will be a one-time, non-recurring event**. The Czech National Bank can either keep the inflation within the conversion limit or it can "let the inflation go" in the first period after accession. After free the rate of inflation for a short period, the National Bank can keep inflation within the limits after stabilisation, during the period decisive for assessing the fulfilment of the conversion criteria.

3.2. Stability of public finances

The criterion of public finance stability has two components. The first one is that an **accession state maintain a maximum of 3% of GDP for the yearly budget deficit**, and the other one is that the **state have a maximum of total public debt less than 60% of GDP**.

According to the estimates of the Czech government, the average budget deficits will exceed 3% of the Czech GDP and they should not begin to fall before 2005. With regard to the fact that the state budget, and public budgets in general, consist mainly of mandatory expenditures, the government has quite a limited space for manoeuvring. One solution to this problem would be a reduction of mandatory expenditures, but that is within the authority of the parliament. Other expected costs for Czech public finances are the costs related to the transformation of the banking sector and the pension system reform.

Therefore, non-fulfilment of the conversion criterion for budget deficits seems to be the main problem of Czech accession to the Eurozone. There are **two solutions** to this problem. One is to **use the 3% limit of GDP as an instrument for disciplining the Czech**

budgetary policy. The second is to hope for a grater tolerance of the Eurozone states and the ECB towards the Czech budget deficit. In the latter case a demonstrated tendency towards reducing the deficit would be enough for the accession to the Eurozone, even if the deficit is actually higher than 3% of the GDP. Particular leniency might be observed if the means were used usefully, for example for transformation and consolidation of the banking industry. However, to rely on the tolerance of the ECB and the current Eurozone members is a **risky strategy** because, among other reasons, such exceptions could endanger the Stability and Growth Pact.

3.3. Exchange rate stability

According to the conversion criterion for exchange rate stability the exchange rate of the Czech koruna must not deviate from a fixed exchange rate with the Euro more that 15% in either direction. If this occurred, the Czech National Bank would either have to intervene at great cost and with doubtful effect, or it would be forced to let the exchange rate leave the band, thus breaking the conversion criterion for Eurozone accession. The effect of interventionist options will be greatly dependent how the ECB takes part in them. A clearly set permitted band will cause a predictable pattern of behaviour by the Czech National Bank, and therefore greater vulnerability of the Czech koruna to speculations.

3.4. Meeting the Maastricht criteria – and then what?

By fulfilling the conversion criteria the candidate country is supposed to prove a sufficient level of **nominal conversion**. However, **some opinion puts forth that candidate countries are so different from the current members of the Eurozone that other criteria should be set - so-called "real" convergence criteria** (e.g. For example reaching a certain level of GDP per capita). Many expert analyses have indicated that **such demands**, even though consistently repeated, **do not have great economic merit or necessity**. The existence of a monetary union is fully compatible with differences in the economic maturity of its members. This compatibility is indicated by the successful membership of the "peripheral economies" (Ireland, Portugal, Spain and Greece) in the EMU despite their lower level of "real" convergence.

4. <u>Accession to the Eurozone: when?</u>

The date of the accession to the Eurozone will be set by a **joint decision of European bodies** (ECB, member states, Commission) **and the Czech Republic**. From the perspective of the Czech Republic, the smoothness of the Euro adoption should be decisive, not the speed.

4.1. Before year 2006/2007

The accession of the Czech Republic to the Eurozone **before 2006 is highly improbable**. It could only be possible through unilateral euroisation or exemption from the two year stay in the ERM II.

4.2. Between 2006-2007

The years **2006 and 2007** are the **earliest realistic dates** for the Czech Republic to join the Eurozone. The date 2006/2007 is attractive because it would mean getting the transition period in the ERM II and the related risks out-of-the-way as early as possible At the same time however it doesn't enable to set suitable parameters of the Czech membership in the Eurozone, which will be evident only after Czech accession to the European Union.

4.3. After 2007

The most probable timeframe for the adoption of the Euro in the Czech Republic is the around 2008. It gives the **Czech Republic a period of 5-6 years for reforms and adjustments necessary for joining the Eurozone** (before as well as after the accession to the EU). The year 2008 would also **enable a short-term withdrawal from the ERM II** (in the case of unexpected difficulties) **or the accession to the ERM II only after 2004, which would enable the Czech economy to "settle down" after the "shock" arising from EU membership**.

5. <u>Czech institutions and the Euro</u>

Several different Czech institutions will have an influence on the Czech accession to the Eurozone. The most important ones are the **government** (proposes the budget), the **Parliament** (the Chamber of Deputies passes the state budget and decides on the bills which determine the mandatory expenses) and the **Czech National Bank** (monetary policy).

In the interest of a smooth preparation for the EMU accession of the Czech economy, it is wise to **consider the possibility of an inter-institutional agreement on the co-ordination**

of the preparation process for the accession to the Eurozone. The agreement should cover both domestic elements and the negotiations with the EU institutions.

6. <u>The symbolism of the Euro</u>

The Euro is not a purely economic instrument, but also a mechanism with a significant **symbolic value**. It can be interpreted in several ways.

6.1. The Euro as a symbol of a full membership in the EU?

The adoption of the Euro in the Czech Republic **can be interpreted as the completion of the integration to the European Union**, or, more simply, as a symbol of a full membership. Another practical and symbolic border between the Czech Republic as a new member state and current member states would disappear. It is also significant, whether the date of the probable adoption of the Euro will coincide with the end of the transition period of the Czech Republic as a new member state.

The Euro as a symbol of a full membership is also reflected in the programmes of some of the political parties. The adoption of the Euro is understood as a symbol of the good state of the Czech economy (Coalition) or it is used as an argument for the postponement of the accession to the Eurozone because of the immaturity of the Czech economy (Czech Social Democratic Party). In both cases it is neglected that membership in the Eurozone is not related to the level of GDP per capita of the state.

However, **Czech accession to the Eurozone should not be interpreted as an inevitable consequence of the accession to the EU**. Firstly, it is not true; the Czech Republic doesn't have to join the Eurozone. Even though the EU indicated that other opt-outs from the monetary union are not negotiable, the non-fulfilment of the convergence criteria can de facto delay the replacement of the Koruna with Euro. Secondly, the Euro issue is interconnected with the complicated questions of the Czech membership in the EU and the whole problem becomes even more confusing in the eyes of the public. Thirdly, the "fatality" of the interconnection could make Czech membership in the EU unpopular – with respective impacts on the result of the referendum on Czech accession to the EU.

6.2. Euro as a symbol of giving up sovereignty?

The interpretation of the adoption of Euro as a next step towards surrender of sovereignty and its transfer to a hardly controllable supranational institution is also quite frequent. A part of this interpretation casts doubts about the project of a common European currency as such – with the emphasis on its apparent failure and the fact that it was motivated above all by political reasons.

Against this interpretation one can easily argue that a small open economy such as the Czech Republic does not really have much monetary sovereignty anyway.

7. <u>On the basis of the analyses mentioned above the European Policy Forum came to the following recommendations and conclusions:</u>

7.1. The classical road towards the Eurozone is far from being optimal for current candidate countries. The convergence criteria were drafted and set under a different set of circumstances and it would be therefore be fitting and desirable to adjust them to the specific conditions of the new candidate countries. In this respect, it would be favourable for the Czech Republic if it could avoid the potentially unstable period in the ERM II - for example by accelerated adoption of Euro . This possibility is however less likely and the Czech Republic should prepare for the accession to the Eurozone in the classical (Maastricht) way as best as it can.

7.2. The fulfilment of most of the convergence criteria should not become insurmountable difficulties. The potentially most problematic criterion is the reduction of the public sector deficits under the required 3% level. This further underlines the generally accepted need of fundamental fiscal reform in the Czech Republic. The set time horizon for the accession to the Eurozone could speed up this reform and prevent the postponement of politically sensitive decisions. Due to the difference in the price levels in the EU and in the Czech Republic the inflation convergence criterion could be exceeded shortly after accession. In the long run it shouldn't be a significant problem, even though the price level in the Czech Republic will stay under the EU average.

7.3. The objections against the Czech accession to the Eurozone based on the optimal currency area theory are hardly defensible in the light of the economic indicators of the Czech Republic. In addition they are based to a large extent on the original Keynesian version of this theory and do not take into account its newest development. The Eurozone is a relatively less suitable area for the adoption of a single currency than for

example the United States, but this doesn't inevitably mean that it is not suitable at all. A strict application of the optimal currency area theory would lead to the disintegration of the EU into tenths of small units with their own currency, where the borders of these units would not correspond with the state borders – that is undoubtedly an absurd idea.

7.4. With regard to the upcoming accession to the EU the Czech Republic should work up a strategy for the entry into the Eurozone. In this respect it is important to set a time horizon for the adoption of the Euro. This would ensure the credibility of the whole process.

7.5. It is not the speed which is important, it is the smoothness of the transition. However there is no reason for postponing the accession and we prefer an earlier date. The most realistic date for the adoption of the Euro in the Czech Republic is the period around 2008, which will give the Czech Republic a period of 5-6 years for reforms and adjustments necessary for joining the Eurozone (before as well as after the accession to the EU)

7.6. The Euro should be presented to the Czech public as a symbol of full membership in the EU, but not as its inevitable consequence. After the accession to the EU the Czech Republic will have the chance to influence whether and when to join the Eurozone. At the same time it should be stressed the fact that accession to the Eurozone will not limit the monetary sovereignty of the Czech Republic, because it is already significantly limited by the (small) size and the (large) openness of the Czech economy.